Investment Commentary
2021 - A Year In Review

31 January 2022

2021 Review – The Markets

OUR FAMILY OFFICE

"It was the best of times. It was the worst of times."

-Charles Dickens
A Tale of Two Cities, 1859

Nothing is more true as we start 2022. It has been the best of times, if you have been long the stock market. It has also been the worst of times as the world continues to battle a pandemic, the end of which we hope is near.

In 2021 the markets flew and the S&P 500 was up over 28% for the year. It hit a new record high 68 times throughout the year – which was the second most in a single year in the last quarter century (in 1995 there 77 new highs reached in that year).

The market started 2021 on a high, continuing the upward leg from the S&P 500 market bottom on April 7, 2020. That very short COVID-19 Bear Market, the shortest ever – just 47 days – was down 34% from the market peak. The upward trajectory for equities continued and then, in April of last year, as if spring fever had hit and with pandemic lockdowns continuing, a new breed of investor took flight.

The trading platform Robinhood and social media network Reddit, which has tens of millions of subscribers, started doing things to stocks that were unheard of, as they were ganging up on short-sellers and pushing valuations to unreal levels. These meme stocks skyrocketed in value despite having no earnings and terrible balance sheets, with AMC up as much as 1200%, and GameStop 700%.

It seems that, when people are working from home and have time on their hands, this new form of gambling can become a past-time. Tens of thousands of investors with just a little money each can do amazing things to stock prices, when they all act the same. This extraordinary buying power in the stock market pushed stock valuations to historically high levels and resulted in a "foot on the gas pedal" for the market most of the year.

In 2021, Apple Inc. became the first publicly-traded company with a $3 trillion valuation. In fact, six publicly traded companies hit the trillion-dollar market value last year. Apple was joined by Microsoft, Alphabet/Google, Amazon, Tesla and Facebook. These six companies were responsible for over 50% of the gain of the S&P 500 last year. The other 494 stocks provided the balance of the market's growth. It was "sky's the limit" and "how high is up?"

This is a new generation/cohort of investors with some money in their pockets and a lot of time on their hands. Many of these investors are new to the world of investing. Perhaps they believe that stocks can only go up and inflation is pegged at 2% annually. Perhaps some believe that mortgage rates will always remain around 2% and they may not be aware that five-year mortgage rates were at 19.25% at one time – back in 1982. Many probably don't realize that housing prices could fall 20% as they did in 1990 – which was the last housing bubble in Canada. It will be very interesting to see how this cohort reacts when the market starts a downturn as it inevitably will – and perhaps that downtrend has already begun.

2021 Review – Interest Rates and Inflation

The year 2021 was also one that started to produce a traumatic increase in the rate of inflation, to a most recent 7.04%, the highest in 40 years. There were many causes to this new phenomenon which include supply chain breakdowns, labour shortages, the increase in oil prices and a sudden burst of spending after widespread lockdowns due to the COVID-19 pandemic.

Unfortunately, as almost everything these days is being politicized – including inflation – the U.S. Federal Reserve, which is supposed to have their hand on the tiller of American monetary policy, has not shown leadership. A few months ago, the Federal Reserve suggested that current inflation is transitory and expected it would only make two increases to interest rates in 2022. The Fed's view now is that there will likely be four rate increases this year. We can count on the Bank of Canada to follow suit. We can't be assured of a typical 25-basis point increase each time our central banks increase rates to gain control over inflation. The concern is that they may choose to shock the markets. There has not been an increase of 50-basis points since May 2000 when the benchmark rate was raised to 6.5%.

For the last 50 years the Fed Funds Rate averaged 5.47% from 1971 to 2021. The lowest was 0.25% (25 basis points) in December 2008, 2015, and today. The highest was in March 1980 when it was 20%.

We believe that inflation is not transitory, and the new higher rate of inflation will stay with us longer than most believe. We do think that interest rates will probably go up a little more slowly than the "shock to the system" some might expect, given the relative uncertainty that still exists around the impact of pandemic variants of concern. The taming of inflation will not succeed as quickly as we would like, but certain asset classes can take advantage of increasing interest rates, like short duration bonds, and short-term mortgages and lending strategies. When existing loans come due within the next 12 months, these will be reinvested at higher rates.

The tight rope that the Fed and Bank of Canada will be walking is how to tame inflation without stifling the economy. Growth will probably slow, but this doesn't mean that we will be in a recession this year. We are concerned about the stock market, as it has been too good for too long. And it has been too easy to make money – especially for first-time investors in the last 12 years. Perhaps we are in the early innings of what could be dramatically increasing volatility in the stock market, and either a correction or a more prolonged bear market are possibilities.

We live by the expression, "we know what we know, and with humility, we know what we don't know." Our greatest concern – and what keep us up at night – is the "unknown unknowns". Our peace of mind comes from creating all-weather portfolios. We believe strongly that asset allocation is the most important aspect of building and preserving wealth. Our portfolios are currently invested in 15 different strategies with much less risk than the stock market, very little correlation to equity markets and with expectations of much better risk-adjusted returns over the next several years. We will always own some equities, but much less than most at this time.

Those of us who have experienced an increase in the rate of inflation and higher interest rates before understand that there will be opportunities presented to us. We look forward to taking advantage of those opportunities.

In our lifetimes, there have always been geopolitical events that have affected economics, the stock market and humanity. It seems that today there are perhaps more reasons than ever to be concerned. The pandemic is a global affair and all countries have been affected and have persevered differently. We are hoping that we see light at the end of the tunnel and the end of the pandemic is near.

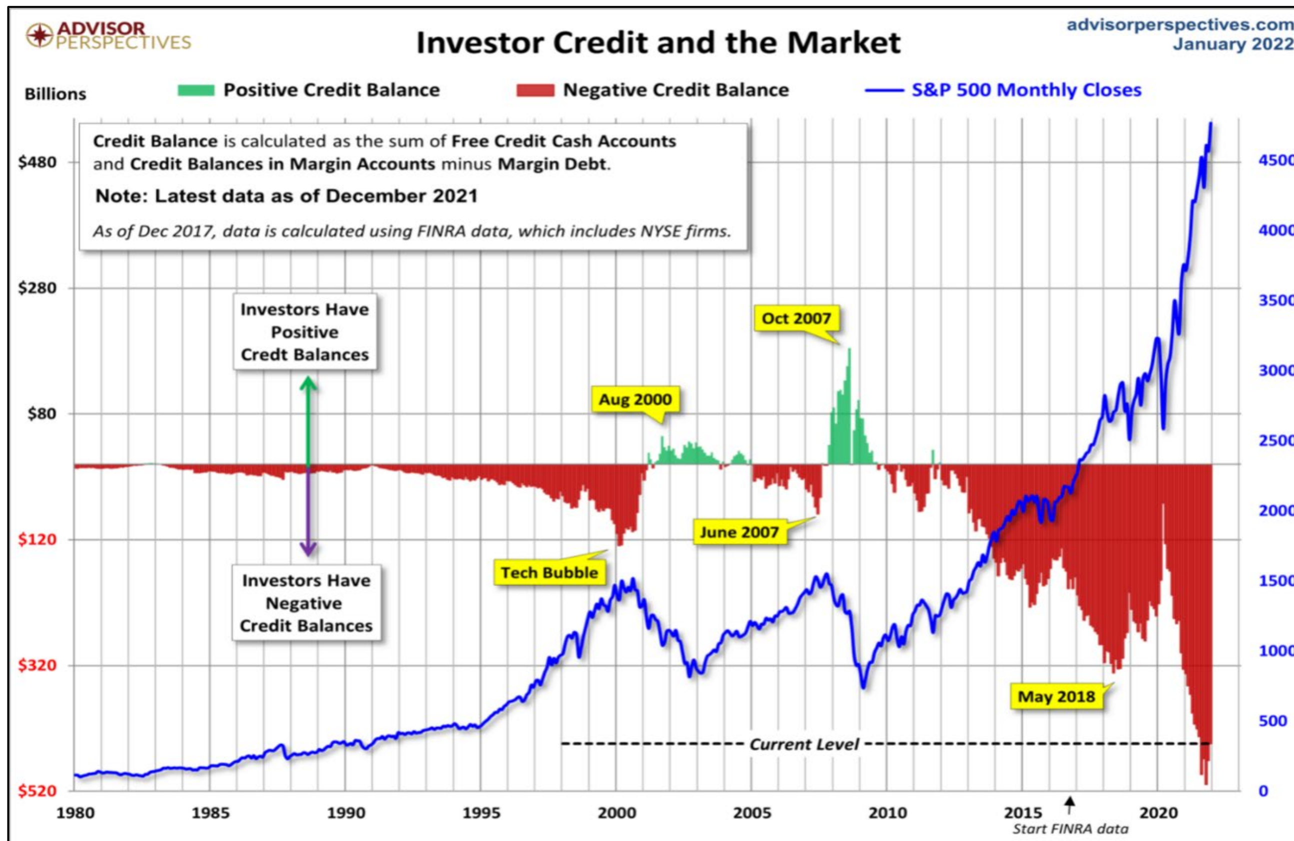
There is a cold war brewing that soon could become a hot one, and we are referring, of course, to Russian forces surrounding Ukraine on three sides. In addition, for the first time in over 150 years, there has been a challenge to American democracy – something we could have never imagined in our lifetimes.

There is also the matter of China, the second largest economy in the world next to the United States, that economists are predicting will become the largest economy by the end of this decade. It is very important to keep an eye on China. Our Chief Investment Officer, Neil Nisker, has been known to say "If China sneezes, the United States catches a cold, European countries get pneumonia, and some might teeter on death."

We are not concerned about the stock market for these reasons alone. These are just some of the many signs that the market might be due for a reset.

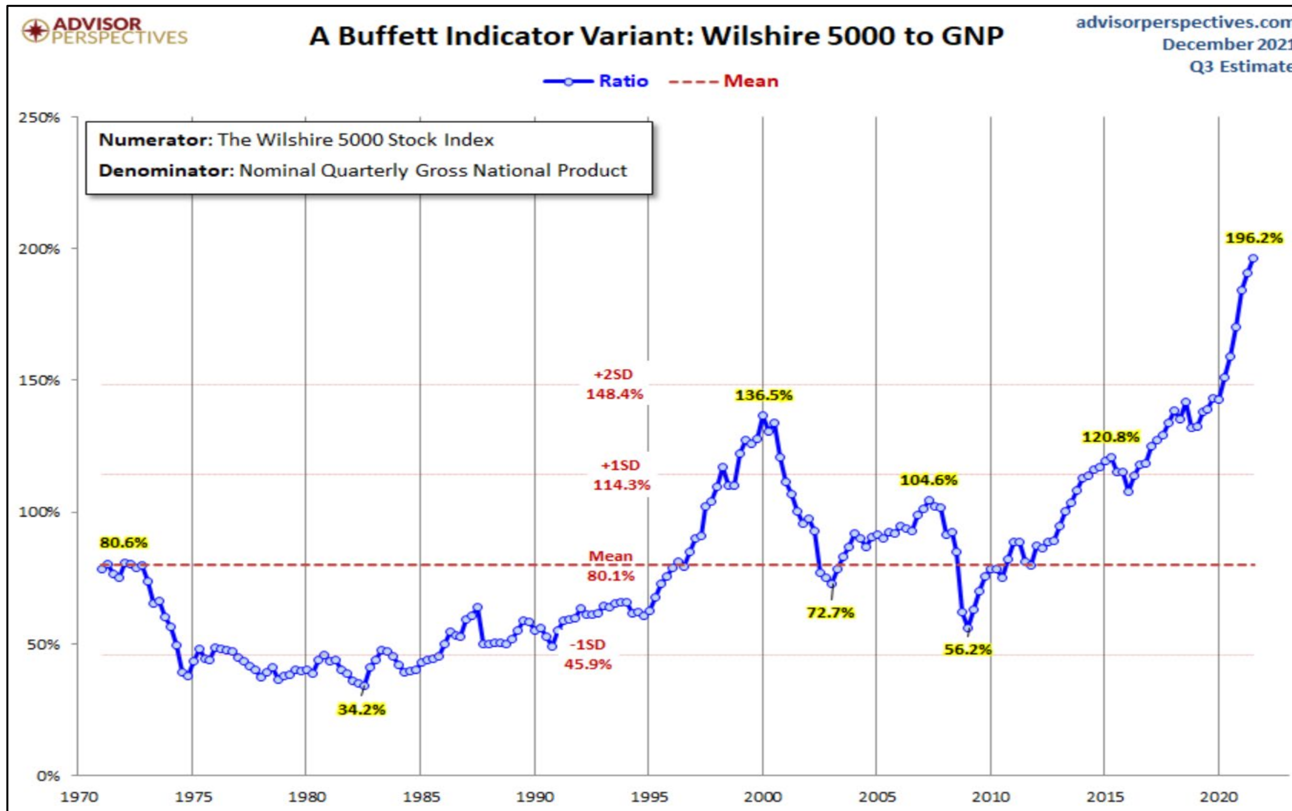
The first three charts in the following pages of this review will demonstrate other concerns about the market, its valuation, and the balance sheet health of its investors.

2021 Review – Charts



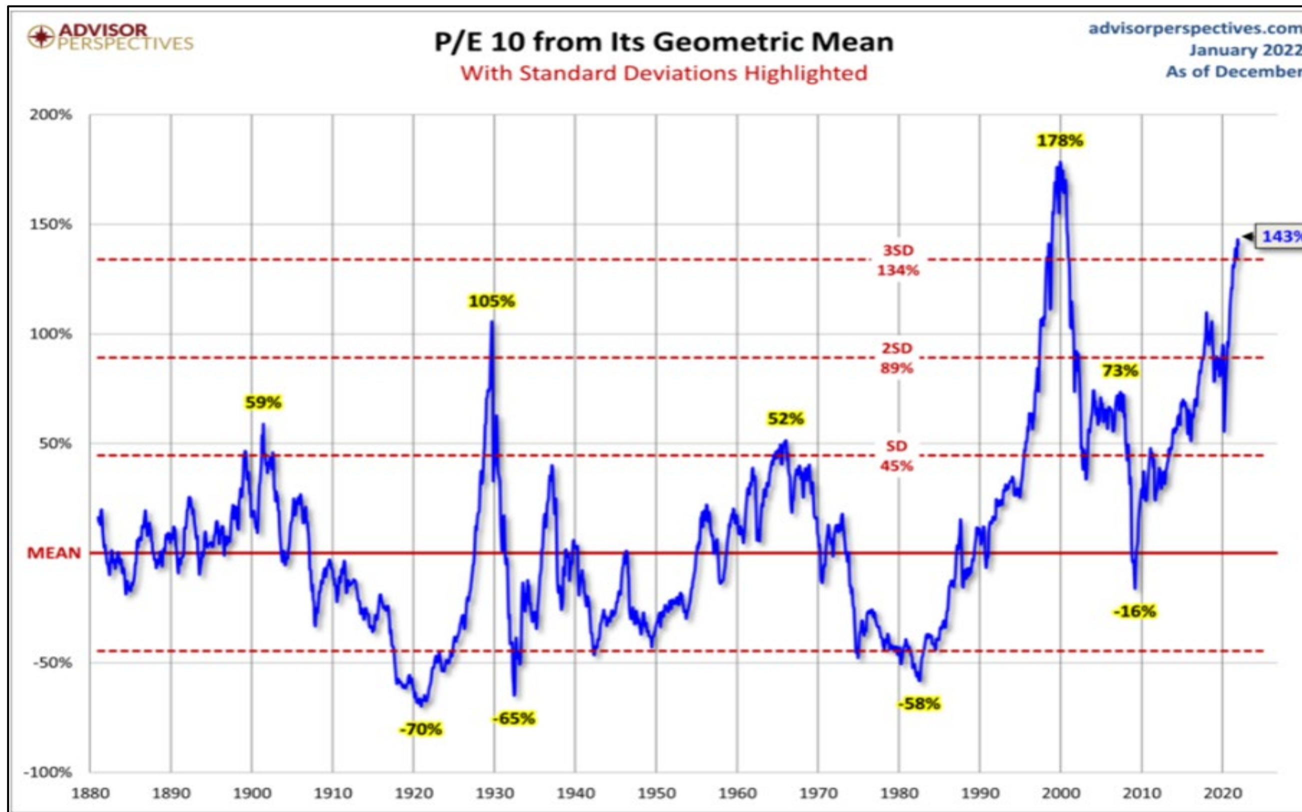
- Investor credit balances and margin debt overlayed with S&P 500 performance over the last 40 years. Investors have historically negative credit balances with the market at new highs.
- As markets fall, there is widespread selling of securities causing margin balances to turn positive since investors are required by their brokers to reduce their debit balances, often more than mitigating it.
- Preceding major recessions such as in the Tech Bubble (2000), the Financial Crisis (2007-2008), credit balances turned to negative extremes – making it a useful indicator to watch for future downturns.

2021 Review – Charts



- The Wilshire 5000 Index, which is a broad-based stock index, divided by the GNP illustrates how risky the market is relative to the last 50 years
- Standard deviation is a measure of risk which quantifies dispersion of a data point (Buffet Indicator at a point in time) from the mean of the data set (Buffet Indicators from 1970 – 2021).
- When the ratio hovers around or breaches 1 standard deviation above the mean the ratio historically becomes unsustainable, and equities tend to correct. We are currently at a three standard deviation event.

2021 Review – Charts



- The P/E 10 ratio divides the price of the S&P500 by a 10-year average of inflation-adjusted earnings, effectively smoothing out fluctuations in the business cycle.
- This 140-year graph showing the Price Earnings (P/E) Ratio with risk being highlighted, shows that the market is currently priced second only to that of the Tech Bubble (2000).
- When the ratio exceeds 2 standard deviations above the mean, bear markets have historically followed. It is now more than 3 standard deviations above the mean. Unless earnings catch up to close the gap, this should be seen as unsustainable.